

DEC - 6 1991

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[REDACTED] Purchase Order

This is in response to your memorandum of August 28, 1991, requesting our opinion concerning the question of whether the [REDACTED], purchase order between [REDACTED] and [REDACTED] constitutes a binding contract for purposes of the safe harbor leasing transitional rules under section 208 (d)(3)(A)(i) of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-34 (TEFRA). Specifically, you request clarification on whether the liquidated damages provision must be construed as of the date of contract execution or at some later point in time.

As a preface, the Conference Report accompanying TEFRA provides that:

[T]he modifications to the safe-harbor leasing provisions do not apply for property placed in the [sic] service before January 1, 1983 if after December 31, 1980 and before July 2, 1982 either (1) the property was acquired by the lessee or construction of the property was commenced by or for the lessee, or (2) a binding contract to acquire or construct the property was entered into by the lessee. For this purpose, a contract is not binding unless the lessee's failure to perform would subject him to liability for damages in an amount equal to or greater than 5 percent of the cost of the property. H.R. Conf. Rep. No. 760, 97th Cong. 2d Sess. 498-499 (1982). (Emphasis added).

The National Office in private letter ruling 8439094 construed a liquidated damages provision as a whole from the date of contract execution. Indeed, this holding follows from the well established principle of contract law, that in assessing the validity of any liquidated damages provision, courts examine the provision as of the time that the contract was executed. See, e.g., Priebe & Sons, Inc. v. United States, 332 U.S. 407, 412 (1947).

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Thus, in order to determine if the purchase agreement between [REDACTED] and [REDACTED] constitutes a binding contract executed between December 31, 1980, and July 2, 1982, we believe the purchase agreement must be construed as whole on the date of its execution to determine whether a failure to perform by [REDACTED], based on the terms of the purchase agreement, would subject [REDACTED] to liability for damages in an amount equal to or greater than 5 percent of the cost of the property.

We believe the central issue in this case then becomes whether the damages provision found in the [REDACTED] purchase agreement constitutes an enforceable liquidated damages provision or an unenforceable penalty. If the damages provision constitutes a penalty, we believe no binding contract would exist for purposes of section 208(d)(3)(A)(i) of TEFRA.

Courts have utilized a wide variety of principles in distinguishing a liquidated damages provision from a penalty provision. Among much useful guidance, the following court opinion provides succinct criteria in distinguishing a valid liquidated damages provision from a penalty. Cegers v. United States, 7 Cl. Ct. 615 (1985). In this Claims Court decision, Judge Lydon focused on three specific factors: 1) did the parties intend to provide for liquidated damages or a penalty; 2) would the anticipated damages from any breach be uncertain in amount and difficult to prove; and 3) does the amount of liquidated damages bear a fair and reasonable relationship to anticipated damages caused by the breach. In essence, if damages were uncertain at the time of execution and the damages provision is reasonable, then the provision would more readily be upheld as a valid liquidated damages clause.

In view of the factual nature of these inquiries, we suggest that you consult with the Appeals Officer and the taxpayer to determine whether damages at the time of contract execution were difficult to ascertain and whether the liquidated damages provision bears a reasonable relationship to anticipated damages caused by a breach. In addition, we note that New Jersey law would most likely be the applicable law governing the enforceability of the alleged liquidated damages provision. Treatises on this subject include Williston and Corbin.

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